THE NEGOTIABILITY OF DEEDS OF TRUST IN VIRGINIA.

NEGOTIABLE notes secured by a deed of trust on real property are in Virginia deservedly well regarded as an investment. From the standpoint of the lender, our form has many striking advantages over the mortgage used in many other states, the most decided being the ease and quickness with which, in event of default in the payment of the notes, the property may be sold and the past due notes paid—a sale after five days advertisement of the time, place and terms of sale without litigation as compared with a tedious chancery suit to foreclose.

When the loan is carefully made, a real estate note offers as high a degree of safety and security for both principal and interest as a first class listed bond, usually at a better rate of interest.

Investors do not lend their money so much upon the notes alone as upon the lien of the deed of trust securing them which follows each transfer of the note without any form of assignment or delivery or even mention of the security.[1] It is important to ascertain whether this lien is as constant a companion of the note in dignity as in attendance.

Although there may be equities between the original parties, although the maker of the notes may have a defense against them in the hands of the original payee, yet by the law merchant a purchaser for value without notice before the maturity of the purchased notes obtains the personal liability of the maker free from all equities.

It is here purposed to discuss whether or not a deed of trust, a writing not negotiable in form, by its relation to the notes it secures becomes negotiable; whether the lien, although originally open to attack, is, when the notes come into the hands of a holder in due course likewise cleansed of all equities and raised in dignity so that the holder may enforce it according to its

[1] Carpenter *v.* Logan, 16 Wall. 271.

terms, or whether its weakness is incurable and the holder in due course will find himself with a personal claim against the maker unquestioned as to liability, but worthless because unsecured.

By the weight of authority in this country a mortgage executed as security for the payment of negotiable paper is a mere incident thereto and partakes of the negotiability of the paper it secures. The courts upholding this view assign as their reason the importance of protecting the holders of commercial paper and say that the negotiable note is the principal thing, while the security, being ancillary thereto, follows the debt, deriving its character from, and sharing the immunity of, the note from defenses and equities so that in proceeding to enforce the mortgage nothing can be alleged against this lien which could not be set up in defense to an action at law upon the notes. Among the courts following this rule may be found the Supreme Court of the United States and the courts of last resort in the States of Alabama, Colorado, Indiana, Iowa, Kansas, Kentucky, Massachusetts, Michigan, Missouri, Nebraska, New Hampshire, New Jersey, North Carolina, North Dakota, Texas and Wisconsin.

The minority view, however, in denying the negotiability of the security, declares that while a mortgage is a mere incident to the debt it secures, yet the importance of this term may easily be over-rated. These courts say that a mortgage is a chose in action and as such is governed by the general law of assignment, and an assignee of the notes secured thereby takes it subject to all equities that could be asserted against his assignor. By this view the noteholder's rights in foreclosure under a deed of trust or mortgage are determined by the principles of equity applicable to non-negotiable instruments rather than by the law merchant. The courts of last resort in the following states support this minority view: Illinois, Louisiana, Minnesota and Ohio.

A survey of the authorities shows that the majority view is probably more recent and since first announced has gained sanction rapidly. It may be that as suggested by the remarks of Ranney, J., in the case of Bailey *v.* Smith,[2] which supports the

[2] (1863), 14 Ohio St. 395, 84 Am. Dec. 385.

minority view, the former general practice of taking a non-negotiable bond with a mortgage was the foundation for the rule that the assignee of the mortgage takes subject to all equities that may be asserted against his assignor. The growing practice of taking negotiable instruments with a mortgage would therefore account for the rapid spread of the doctrine of derived negotiability of the mortgage as a distinction to the former rule.

It is submitted that reason as well as the weight of authority support the majority view.

Vast sums of money are invested in negotiable notes secured by deeds of trust on real property and the notes themselves, being continually negotiated by outright sales or by use as collateral security for another loan, take an important place in our commercial life. To hold that the security does not share with its notes the immunities of negotiability, would be to put an intolerable clog on the freedom of contract, and to the disadvantage of both the borrower and lender. The law should follow business, and the same reasons that give a holder in due course of negotiable paper a favored place are grounds for a decision holding that the security derives negotiability.

When a borrower executes negotiable notes and a deed of trust on his property to secure them, he knows that the notes with a memorandum thereon of their security will probably come into the hands of innocent purchasers. To hold that after this has happened he can withdraw the security will be to introduce into a transaction that should be conclusive, a lack of finality—a never failing course of litigation. It might be remarked that the number of cases on this point in any state supporting the minority view is at least double the average number in the states supporting the majority view.

It is also worthy of note in this connection that the courts of last resort of Illinois, a state in which the minority rule obtains, although not overruling the earlier cases endeavor to restrict rather than extend the rule and the legislature has attempted to reverse this doctrine by statute so as to make the laws of the state conform in this respect to those obtaining almost every-

where else.[3] The Federal Circuit Court of Appeals in O'Rourke *v.* Wahl,[4] in passing on a case arising in this state, did not consider itself bound by the long line of state decisions upholding the minority view, but followed the majority view as set forth in Carpenter *v.* Longan,[5] deciding that the assignee had the same rights in the mortgage as in the notes, and, although the transaction was fraudulent as between the original parties, the assignee being the holder in due course could enforce both note and mortgage.

Under either view a defense that would be upheld against the holder in due course in an action upon the notes would apply to prevent enforcement of the mortgage. A striking example is the case of First National Bank *v.* Wade,[6] where the plaintiff an illiterate colored woman over seventy years of age was induced by fraud and without negligence on her part to sign negotiable notes and a mortgage securing them under the belief that she was signing her last will and testament and a power of attorney. The notes and the mortgage securing them were transferred to a holder in due course. Upon a bill seeking cancellation it was held that fraud *in factum* was proved and the notes and security in the hands of a holder in due course were cancelled.

It is where the maker of the note by reason of fraud in the procurement, misrepresentation, and similar personal defenses could successfully defend an action at law by the original payee that the importance of the question is seen. Some cases supporting the majority view by declaring that the law merchant applies to the rights of the parties to the transaction and all other third parties, use language broad enough to protect the security of the holder in due course against the demands of the maker's creditors or trustee in bankruptcy, which are based on statutory grounds and could be successfully prosecuted against the original parties.

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[3] 27 Cyc. 1325.
[4] 109 Fed. 276.
[5] 16 Wall. 271.
[6] 27 Okla. 102, 111 Pac. 205, 35 L. R. A. (N. S.) 775.

The question of derived negotiability has not yet been presented or squarely decided in this State. In Stimpson *v.* Bishop,[7] the court in declaring that the transfer of a debt secured by a deed of trust carries with it a security, cites the leading case of Carpenter *v.* Longan,[8] which holds the security to be negotiable. In Augusta National Bank *v.* Beard,[9] it is said that a mortgage is but a mere security for the debt and collateral to it. There is little however in such expressions to warrant the opinion that the majority view prevails in this State.

Dean Lile, of the University of Virginia Law School, in his Notes on Equity Jurisprudence,[10] says that the case of Evans *v.* Roanoke Savings Bank,[11] seems to be authority for the proposition that a deed of trust does not derive negotiability from the notes it secures. In that case Reed was the owner of certain real estate in the City of Roanoke and executed a deed of trust thereon to secure certain negotiable notes. The deed was duly admitted to record and the notes transferred by Myers, the payee, to the Roanoke Savings Bank, a holder in due course. Shortly thereafter Myers, by marginal release, fraudulently released the said deed of trust, and Reed executed another deed of trust on the property securing a new loan to a creditor who had no notice of the fraud. In the subsequent contest between the second creditor and the bank it was held that their equities being equal the legal title held by the second creditor should prevail.

Section 2498 of the Virginia Code has been since amended so that it is now provided that the notes secured duly cancelled shall be produced before the clerk when the marginal release is made. Such provision however is not sufficient to protect a subsequent purchaser although the record is clear.[12]

The Evans case approves and cites at length from Williams *v.*

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[7] 82 Va. 190, 200.

[8] 16 Wall. 271.

[9] 100 Va. 687, 42 S. E. 694.

[10] Lile, Notes on Equity Jurisprudence, p. 14.

[11] 95 Va. 294, 28 S. E. 323.

[12] Brooking *v.* Nolde (forged notes), decided by Judge Daniel Grinnan, sitting in the Chancery Court of the City of Richmond, Virginia, and reported in 11 Va. Law Reg. 217.

Jackson, [13] in the United States Supreme Court, where the majority view obtains. In this case the trustee fraudulently and in violation of his duty to the holder in due course of the notes secured, released the deed of trust and the rights of the subsequent purchaser who purchased on a clear record were held superior to those of the noteholder.

There is no party in a mortgage occupying a position similar to that of a trustee in a deed of trust—an agent of the parties, holding the legal title, notice to whom is notice to the beneficiaries and whose power, as distinguished from authority, to release always exists.[14] A release by the trustee although tortious carries the legal title. Since in Williams *v.* Jackson,[15] the subsequent purchaser actually obtained the legal title and, as the equities were equal, his rights were held superior.

It is submitted that this principle is eminently sound. A noteholder should satisfy himself as to the character of the trustee and whether he knows of any equities against the notes or unrecorded liens against the property. Having selected his agent he should be bound by his acts so far as not to work a hardship on innocent purchasers relying thereon, and be left to his remedy upon the notes and against the trustee for his wrongful or negligent act.

The Evans case represents no question of agency, for the release was made by the original payee and is closely analogous to the fraudulent release of a mortgage. In an annotation to the case of Central Trust Company *v.* Stepanek,[16] in the Lawyers Reports Annotated, New Series, the controlling principle is announced as follows:

> "The holder of an unrecorded assignment of a mortgage, whether such assignment of writing or by operation of law because of the transfer by indorsement of a note to which the mortgage is incident, is entitled, if he has possession of

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[13] 107 U. S. 478.
[14] Merchants Bank *v.* Ballou, 98 Va. 112, 32 S. E. 481.
[15] *Supra.*
[16] 138 Iowa 131, 115 N. W. 891, 15 L. R. A. (N. S.), 1025.

> the note and mortgage, to priority over any subsequent rights claimed in the property covered by the mortgage by any *bona fide* purchaser or subsequent encumbrancer without notice of the assignment and who has relied upon a recorded discharge of the mortgage by the mortgagee, unless the recording acts make it the duty of the assignee to record his assignment." [17]

The doctrine of derived negotiability is further recognized and the rights of the parties held to depend on the recordation of the assignment of the notes which course was suggested in Williams *v.* Jackson,[18] as a protection for a subsequent purchaser.

Although a mortgage or deed of trust is a simple security for the debt secured and when considered in connection therewith is personal property,[19] and further, assignment of choses in action are not required to be recorded, and such recordation if made would not constitute constructive notice to third parties,[20] yet the Evans case might be claimed to be authority for the proposition that the assignment of notes secured by a deed of trust should be recorded, which practice, it may be safely predicted, will not become general until our present tax laws on intangibles of this nature are amended.

It would probably be better to regard the Evans case as the solution of a particular case presenting great difficulty by reason of the legal effect of acts possible under an experimental statute, rather than a leading case laying down the rule that deeds of trust are not negotiable or that assignments of notes secured under a deed of trust must be recorded. For the present the question is open in this state.

It would be well in view of the general importance of the subject if the direct question of the derived negotiability of deeds of trust were presented to the Court of Appeals in the near future, and some "coarse sharp-cut law" (to use Judge Bleckley's words) laid down. The usual wording of our deeds of trust—

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[17] 15 L. R. A. (N. S.) 1025. [18] *Supra.*

[19] Augusta National Bank *v.* Beard, 100 Va. 687, 42 S. E. 694.

[20] Gordon *v.* Rixey, 76 Va. 101; Daily *v.* Warren, 80 Va. 572; Ginter *v.* Breeden, 90 Va. 565, 19 S. E. 656.

that the property is conveyed in trust to secure to the holder of the hereinafter described notes the payment of $5,000.00 as is evidenced by certain negotiable notes made by the grantor payable to his order and by him endorsed—and the extent to which our commercial life is involved will, it is hoped, lead to the adoption of the majority view in Virginia.

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